Office - Supreme Court, U.S.
FILED
SEP 8 1982
ALEXANDER L. STEVAS,
CLERK

No. 82-162

In the Supreme Court of the United States

OCTOBER TERM, 1982

CAROL W. HILTON, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

Page

Cases:

Estate of Franklin v. *Commissioner*, 544 F. 2d 1045 ..... 4, 5

Frank Lyon Co. v. *United States*, 435 U.S. 561 ..... 4, 5, 6

Helvering v. *F. & R. Lazarus & Co.*, 308 U.S. 252 5

Sun Oil Co. v. *Commissioner*, 562 F. 2d 258, cert. denied, 436 U.S. 944 5

Thompson v. *Commissioner*, 631 F. 2d 642, cert. denied, 452 U.S. 961 5

In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-162

CAROL W. HILTON, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioners seek review of the decision below denying their claims to income tax deductions arising from transactions found to be devoid of economic substance.

The pertinent facts are as follows: In 1965, Broadway-Hale Stores, Inc. ("Broadway-Hale") held title to a 12-acre parcel of unimproved land in Bakersfield, California, for which it had paid approximately $200,000 (Pet. App. 22). In order to obtain long-term financing for the construction of a retail department store upon the property, Broadway-Hale entered into an agreement in March 1965, with a brokerage and investment firm, Wood, Struthers & Winthrop ("Wood, Struthers") (Pet. App. 22-23, 76-78). Wood, Struthers agreed to organize a corporation, Fourth Cavendish, that would purchase the store from Broadway-Hale upon the completion of its construction and simultaneously lease it back to Broadway-Hale together with the underlying land. Broadway-Hale and Wood, Struthers further

agreed that Fourth Cavendish would acquire the funds needed for the purchase from the issuance of its mortgage notes to specified insurance companies whose commitments to buy the notes already had been obtained (Pet. App. 22-23, 76-78).

In 1967, upon completion of construction of the store, Broadway-Hale and Wood, Struthers carried out the sale and leaseback in accordance with the terms of their agreement. With a capital of $1,000, Wood, Struthers incorporated Fourth Cavendish, which issued its notes to the insurance companies. Out of the proceeds of the notes, Fourth Cavendish paid Broadway-Hale $3,137,500 for title to the store and to the underlying land (Pet. App. 25-29, 77-79). Fourth Cavendish thereupon leased the store and land back to Broadway-Hale under a "net" lease that provided for a 30-year initial term and gave Broadway-Hale options to renew for an additional 68 years (Pet. App. 78). The annual rentals payable by Broadway-Hale under the lease did not reflect the fair market rental value of the property (Pet. App. 39-40). For the initial term, the annual rentals of $198,603.75 were supposed to provide just enough funds to amortize 90 percent of the principal amount of the notes issued by Fourth Cavendish. For the renewal terms, if any, the rentals will be reduced to less than $50,000 per year (Pet. App. 40, 78-79). As security for its notes, Fourth Cavendish granted the insurance companies a mortgage on the property and assigned to them the rents payable under the lease (Pet. App. 27-29, 78).

As a final step in the transaction, on December 20, 1967, Fourth Cavendish transferred its interest in the property by deed to Medway Associates, a newly formed partnership with a capital of approximately $10,000, organized by members of Wood, Struthers for the purpose of taking and holding title to the property. Medway acquired title to the property subject to the lease to Broadway-Hale, to the lease

agreement, and to the mortgage, among other circumstances. It paid no consideration. It did not assume, and later formally disclaimed, liability for the obligations encumbering the property (Pet. App. 29, 31-33, 79).

Petitioners' participation in this transaction stemmed from an agreement made in November 1967, between Wood, Struthers and Jack R. Young, Associates, Inc. which authorized Young to sell interests in Medway to buyers of his choosing (Pet. App. 30-31). During 1967 and 1969, petitioners paid a total of $335,000 for interests entitling them to share, as limited partners, in the profits and losses of Medway (Pet. App. 45-60). This amount was distributed in its entirety to the promoters of the transaction as "compensation for services," including commissions (Pet. App. 59-63). For each of the years 1967 through 1970, Medway claimed deductions on its partnership tax returns for these payments to the promoters, as well as for depreciation on the store and for interest on the debt encumbering the store (Pet. App. 67-70). Medway claimed on its returns that it had a depreciable basis of approximately $3 million in the store (Ex. 53-BA). As a result of these deductions, Medway reported a loss for each year in suit. On their individual income tax returns for those years, petitioners claimed deductions to reflect their respective distributive shares of the losses reported by Medway (Pet. App. 67-75).[1]

On audit, the Commissioner disallowed petitioners' claims to these deductions. He found that none of the partnerships in which petitioners held interests, and no transaction in which any partnership was involved, had a business purpose or economic reality aside from the avoidance of taxes (see Pet. App. 14). The Tax Court upheld the

---

[1] Medway's reported losses passed down to petitioners through "tiers" of interposed partnerships (Pet. App. 67-75).

Commissioner's deficiency determinations (Pet. App. 7-120). It concluded that petitioners had failed to satisfy the requirement of this Court's decision in *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 583-584 (1978), that they show "a genuine multi-party transaction with economic substance" (Pet. App. 110). As the Tax Court viewed the transactions in this case, "the limited partnership from which petitioners seek to derive their deductible losses, is a mere conduit through which Broadway's debt payments pass on their way to the insurance companies" (*ibid.*). It followed, the Tax Court held, relying on *Estate of Franklin* v. *Commissioner*, 544 F. 2d 1045 (9th Cir. 1976), that petitioners lacked a bona fide investment on which to predicate deductions for depreciation and interest (Pet. App. 110-111). The court of appeals affirmed for the reasons stated in the Tax Court's opinion (Pet. App. 3-5, 134). It agreed that *Estate of Franklin* applied to this case and that the sale-leaseback transaction in *Frank Lyon Co.* was distinguishable (Pet. App. 4).

1. The decision below correctly denied petitioners' claims to deductions that arose from a transaction devoid of economic substance. As both courts correctly concluded, there was no reason for petitioners' participation in this transaction apart from its anticipated tax consequences (Pet. App. 4-5, 104-105).

The findings underlying that conclusion have an ample basis in the record. Petitioners failed to show that they or Medway possessed an interest of substance in the leased property that would support deductions for depreciation and interest. The projected cash flow to them from the property did not justify their participation. Under the lease, which Broadway may extend at its option for up to 98 years, the rents for the first 30 years are dedicated in their entirety

to servicing the mortgage debt. For any subsequent term, the rents are little more than nominal and would constitute a return, beginning in 1998, of only one percent or one and one-half percent on Medway's putative investment of $3,137,500 (Pet. App. 39-40, 78-79, 96-99, 104-105). Contrary to petitioners' contention (Pet. 20-21), neither Medway nor petitioners were accumulating a valuable equity in the property. The record therefore fully supports the Tax Court's determination that the projected value of the property at such time as the lease expires was too conjectural to warrant serious consideration (Pet. App. 63-65, 93-105). Moreover, in the event Medway proposed to sell its interest in the property to a third party, Broadway-Hale had the right to purchase the interest for $50,000 (Pet. App. 42-43, 99-101).

On the basis of these facts, the Tax Court properly determined that petitioners' interest in the property was far less than the approximately $3 million they ascribed to it. In no meaningful sense did they have an investment in the property that would entitle them to the tax benefits they seek. *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252 (1939); *Estate of Franklin* v. *Commissioner*, 544 F. 2d 1045 (9th Cir. 1976); *Thompson* v. *Commissioner*, 631 F. 2d 642 (9th Cir. 1980), cert. denied, 452 U.S. 961 (1981); *Sun Oil Co.* v. *Commissioner*, 562 F. 2d 258 (3d Cir. 1977), cert. denied, 436 U.S. 944 (1978).

2. Contrary to petitioners' further argument (Pet. 7-9, 23-24, 28-29), the Tax Court correctly applied the teaching of this Court's decision in *Frank Lyon Co.* v. *United States, supra*, 435 U.S. at 572-573, 583-584, and the court of appeals properly agreed that the sale-leaseback transaction in *Frank Lyon Co.* was distinguishable (Pet. App. 4-5, 81-88, 104-110). The lessor in *Frank Lyon Co.* was "an ongoing enterprise" that committed $500,000 of its working capital to that transaction, chiefly to diversify its

business. See 435 U.S. at 576-577, 581-583. As the Tax Court found, the Medway partnership in this case was "a mere conduit" formed and maintained for no purpose other than to take and hold title to the property leased to Broadway-Hale (Pet. App. 110). Unlike the situation in *Frank Lyon Co.*, petitioners have failed to show that the sale-leaseback in this case was a genuine multiparty transaction with economic substance.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

SEPTEMBER 1982

DOJ-1982-09